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In the Supreme Court of the United States

OCTOBER TERM, 1985

PIGGY BANK STATIONS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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Petitioner seeks review of the court of appeals' decision below affirming the disallowance of certain claimed bad debt deductions.[1]

1. Sam S. Klink and William Johnstone owned equal shares of two affiliated corporations, Piggy Bank Stations, Inc. (petitioner), and Piggy Bank Land, Inc. (Land). Petitioner operated gasoline stations, some of which it owned; others were leased from Land or other unrelated parties. Klink was also one of two equal partners in the Browne & Klink partnership (B & K). B & K's projects included, but were not limited to, locating sites and designing and constructing gasoline stations for petitioner. Klink, Johnstone,

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[1]The opinion of the court of appeals (Pet. App. A33-A41) is reported at 755 F.2d 450. The opinions of the Tax Court (Pet. App. A1-A19; A23-A32) are unofficially reported at 51 T.C.M. (P-H) 1579 and 52 T.C.M. (P-H) 2765.

petitioner, and others were shareholders in General Computer Services, Inc. (Computer), which marketed computer programs that had been developed originally for petitioner's accounting purposes. Pet. App. A33-A34. Computer was undercapitalized and was never profitable (*id.* at A17).

From 1972 to 1974, petitioner paid many of Computer's operating expenses. Computer executed demand notes for some advances, and other advances were reflected as receivables on petitioner's books. Computer never paid any principal or interest on these advances. Pet. App. A13. The advances were made when Computer was insolvent and were subordinated to other loans. Thus, repayment was completely contingent on future profits. *Id.* at A17-A18. By the end of petitioner's 1975 tax year these advances totalled $294,367, and that amount was claimed as a deduction for bad debts. In 1976, an additional $21,000 bad debt deduction was claimed. *Id.* at A2. Petitioner also made various transfers totalling $244,870 to B & K and claimed a deduction on its 1976 return for a bad debt deduction in that amount (*ibid.*).

2. The Commissioner disallowed both deductions and determined deficiencies in petitioner's income taxes. The Tax Court found that petitioner had not established that the "advances * * * [to Computer] constitute indebtedness for Federal tax purposes" (*id.* at A19). The court similarly found that petitioner had not established that the advances to B & K "constituted debts" (*id.* at A12). In a supplemental opinion (*id.* at A23-A32) the Tax Court affirmed its original holding, adding that "[s]ome portion of [the B & K advances were] unquestionably * * * advances in connection with the modification, construction, reconstruction or equipping of one or more filling stations for operation by" petitioner (*id.* at A27).

The court of appeals affirmed. With respect to the advances to Computer, the court concluded that the disbursements were contributions to capital rather than loans (Pet. App. A40). With respect to the advances to B & K, the court concluded that the advances were payments for construction work rather than loans (*id.* at A38).

3. With respect to the advances to Computer, petitioner asserts (Pet. 4-6) that this case presents an appropriate vehicle to resolve an alleged conflict over the test for when advances to a corporation are loans and when they are capital contributions. The court of appeals, relying on *Texas Farm Bureau* v. *United States*, 725 F.2d 307 (5th Cir. 1984), cert. denied, No. 84-276 (Jan. 7, 1985), analyzed the disputed disbursements by considering the following factors: (1) the names given to the instruments evidencing the advances; (2) the presence or absence of a fixed maturity date; (3) the source of the payments; (4) the right to enforce repayment; (5) the resulting participation in management; (6) the presence or absence of subordination; (7) the parties' intent; (8) "thin" or adequate capitalization; (9) the identity of interest between creditor and stockholder; (10) the source of interest payments; (11) the corporation's ability to obtain third-party loans; (12) the use to which the advances were applied; and (13) the failure of the debtor to repay in a timely fashion.[2] Petitioner suggests that the court of

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[2]These same factors have been recognized as relevant by the various courts of appeals. The courts uniformly stress that the factors are not of equal weight and that no one factor controls. See *Casco Bank & Trust Co.* v. *United States*, 544 F.2d 528, 532 (1st Cir. 1976), cert. denied, 430 U.S. 907 (1977); *Gilbert* v. *Commissioner*, 248 F.2d 399 (2d Cir. 1957), on remand, 262 F.2d 512, 514 (1959), cert. denied, 359 U.S. 1002 (1959); *Fin Hay Realty Co.* v. *United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Jewell Ridge Coal Corp.* v. *Commissioner*, 318 F.2d 695, 699 (4th Cir. 1963); *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970); *In re Uneco, Inc.*, 532 F.2d 1204, 1208 (8th Cir. 1976); *A.R. Lantz Co.* v. *United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); *Hayutin* v. *Commissioner*, 508 F.2d 462, 473 (10th Cir. 1974); *In re Lane*, 742 F.2d 1311, 1314-1315 (11th Cir. 1984); *Post Corp.* v. *United States*, 640 F.2d

appeals' decision turned almost exclusively "on the ground that * * * repayment * * * was contingent on the future profitability of Computer" (Pet. 4). This is clearly incorrect. The court of appeals explained (Pet. App. A40-A41) that virtually every relevant factor supported the Tax Court's determination.[3]

4. Petitioner contends (Pet. 8-9) that the court of appeals erred "by requiring a tracing of the use of advanced funds in the hands of B & K in order to establish a business purpose for the loan" (Pet. 8). That contention mischaracterizes the basis of the lower courts' opinions. The asserted bad debts were disallowed because petitioner did not meet its burden of establishing that the advances were loans. See *Welch* v. *Helvering*, 290 U.S. 111 (1933). Petitioner's proof established only that it advanced sums to B & K, its general contractor, for the construction of filling stations that petitioner would own. Those sums generally were progress payments for construction work and accordingly were not deductible as bad debts. While B & K also might have developed other projects for which petitioner theoretically could have lent it money, petitioner failed to introduce any evidence to establish that any of the advances were utilized for those other projects, even though the Tax Court reopened the record specifically for that purpose (Pet. App.

1296, 1307 (Ct. Cl. 1981). There is therefore no merit to the contention that there is a conflict in the circuits with respect to their treatment of this question.

[3]There is no merit to petitioner's argument (Pet. 6-8) that, because Greyhound advanced Computer substantial sums in January 1975, the court of appeals erroneously found and relied on the fact that third-party loans were not readily available to Computer. Petitioner fails to recognize that the Greyhound advances were made in conjunction with Greyhound's purchase of all of Computer's assets (Pet. App. A15); thus, they were not made by a totally disinterested third-party. See *id.* at A41 n.2.

A30, A39). Thus, the claimed bad debts were disallowed without regard to whether the advances had a business purpose.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Acting Solicitor General

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